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Financial indulgence

Cheap credit is tempting emerging markets towards risky borrowing

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"ORIGINAL sin" in the economic scriptures differs slightly from its theological counterpart. It is the observation, made in the aftermath of the emerging-market crises of the 1990s, that most countries are unable to borrow from foreigners in their own currency. Foreign-currency borrowing damns them, in times of trouble, to a vicious downward spiral: a loss of faith in a country's currency makes its debts harder to repay. That in turn further reinforces doubts about its currency.

Of late this doctrine has begun to look a bit old-fashioned. Financial globalisation has freed many developing economies from the need to go cap in hand to foreign financial markets. With investors willing to lend in local markets (and often in the local currency), they have sharply reduced their overseas borrowing over the past decade. Yet some economists worry that their salvation remains incomplete. Old vulnerabilities are creeping back.

The 1990s crises were a Damascene moment for emerging markets, prompting broad changes in policy. Many developing countries managed to introduce serious fiscal and monetary reform. This cut overall borrowing needs and also reassured adventurous rich-world investors who were considering a plunge into emerging economies' domestic bond markets. Most abandoned hard-currency pegs, smoothing their adjustment to shifting capital flows, and many accumulated large stocks of foreign-exchange reserves. Above all emerging markets sought to escape original sin.

Financial integration has helped. The International Monetary Fund's latest *Global Financial Stability Report* points out that gross capital flows to emerging markets roughly quintupled from 2000 to 2010. From 2002 to 2010 the share of emerging-market debt issued in foreign markets dropped from 27% to 12% (see chart, left panel). This, in turn, helped governments reduce their vulnerability to sudden swings in exchange rates. In 1998 nearly a third of Turkey's marketable government debt and more than half of that in Mexico was denominated in a foreign currency. By 2010 the share in both economies was below 20%.

That discipline has, however, begun to erode. In the aftermath of the global financial crisis, rich-world central banks unleashed a flood of liquidity to support their own sickly economies. As the deluge depressed interest rates investors went hunting abroad for better returns. Governments in emerging markets have mostly remained disciplined through this onslaught; the share of emerging-market government debt issued in foreign markets has continued to drop, from 12% in 2008 to 8% last year. Private firms, however, have been more likely to succumb to temptation.

Emerging-market companies have begun issuing foreign-currency-denominated debt with gusto: $1.3 trillion of it was outstanding in 2013, up from $597 billion in 2009, according to Nomura, a Japanese bank. As a result, foreign borrowing as a share of all emerging-economy borrowing has been climbing. Banks are leading the way. Since late 2008 the share of debt issued by financial firms abroad has risen steeply, from 15% to 22%, the IMF says.

Moreover, official figures on external borrowing may not capture the entire picture because of "hidden debt" being accumulated by emerging-market firms. Conventional measures typically include debt securities issued domestically and official cross-border bank lending—but not bonds issued in foreign markets by emerging-market multinationals. In a 2013 paper Hyun Song Shin, of Princeton University, and Laura Yi Zhao, of the Asian Development Bank, warned that nonfinancial firms may be borrowing cheaply abroad to make loans at home.

If bonds issued abroad by the foreign subsidiaries of Indian and Chinese firms are included in their national statistics, then the foreign-currency debt of non-financial firms looks twice as large as under the usual measure. Foreign issuance by Brazilian firms more than doubles its stock of private-sector external debt, according to a new Inter-American Development Bank report. Growth in this hidden debt has soared since 2008.

Whether these excesses amount to mortal sin is not easy to judge. New debt estimates assembled by Nomura take account of countries' foreign-currency exposure via "hidden" offshore bonds. Such borrowing makes some economies look shakier, it reckons, but not much. Hidden debt in Brazil and Russia amounts to 5% or more of GDP. But overall foreign-currency exposure is generally below the average of the past two decades (see chart, right panel). Nomura's adjustment raises China's foreign-currency debt from 9.2% of GDP to 9.3%: hardly the stuff of doom.

Living on a prayer

If there is little sign of imminent disaster, there is good reason to be vigilant. The flood of money from America and Britain may soon dry up, but the euro zone and Japan seem likely to keep providing yield-hungry investors, eager to lend on tempting terms. The trend towards foreign borrowing bears watching.

What is more, having only a small foreign-currency exposure may no longer be enough to protect emerging economies from swings in global sentiment—and monetary conditions. The financial maturation that allowed emerging economies to do more of their borrowing locally has necessarily raised foreign participation in local-government bond markets. In some economies, the share of local-market government debt owned by foreigners has more than doubled since 2009.

Investors continue to do a poor job discriminating between developing markets based on the underlying health of their economy. And stampeding capital can still apply uncomfortable financial pressure, as the market wobbles of the past year revealed. Falling currencies may hurt exposed firms' balance-sheets, thereby weakening investment and the outlook for growth. An abrupt growth slowdown looks preferable to the crises of the late 1990s. But it is no Eden.

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